$50.00 ANNUALLY
40 Letters Per Year

DOW THEORY LETTERS

"The Market as Interpreted under the Dow Theory"

RICHARD RUSSELL
P. O. Box 15196
San Diego 15, California

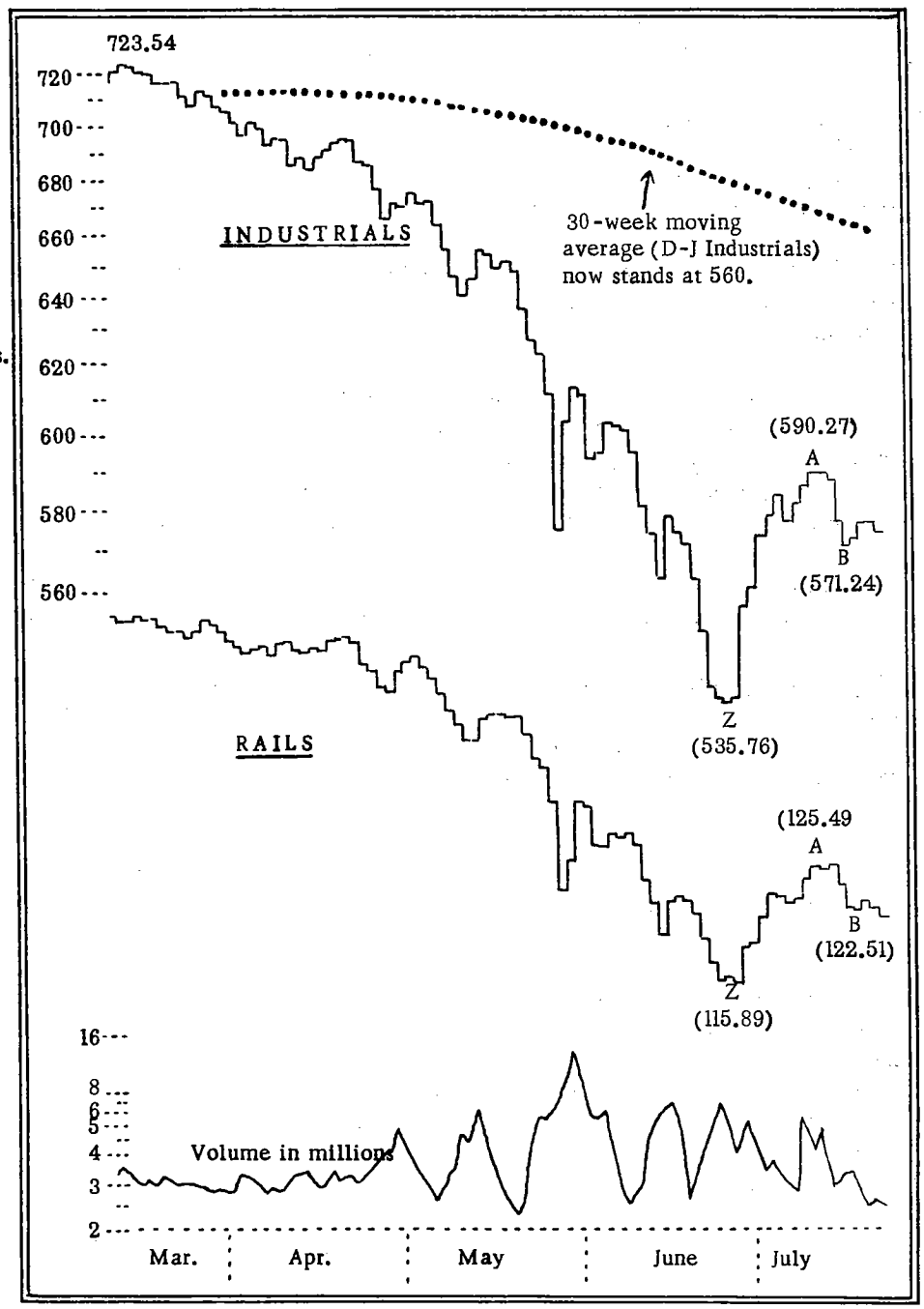
Registered with the Securities and Exchange Commission

July 25, 1962 Number 188

During every primary swing one can hear the roar of those who insist on arguing with the Averages. Only a few months ago our President, our Secretary of the Treasury, and numerous other high officials were insisting that "this was another 1946" and that the Averages were simply reflecting "a change in price-earnings ratios brought on by second thoughts regarding inflation."

Now comes the relentless march of the statistics. What the market foresaw is slowly coming to light. Retail sales recede, housing starts fall off, durable goods orders drop while inventories climb, average work hours decline, steel production contracts while steel prices weaken, gold continues to leave the country, sensitive business indices slide, commodities weaken still further.

This is the reason why Dow's Theory endures. It's inferences and conclusions are drawn from the movements of the market. And the market is bigger, "smarter", and more honest than all our indicators and forecasters lumped together. Recently, a great deal has been done with various "lead, coincident and lag indicators" in an attempt to provide economists with a more sensitive thermometer of the nation's condition. But the market has been using these indicators for years. It not only uses them, it anticipates them. And at times (as over the past six months) it even influences them.



THE MARKET The initial Industrial rise from the June 26 extreme low closing of 535.76 (Z on chart) to the recent July 12 recovery high of 590.27 (A) retraced 29% of the ground lost during the second primary bear leg. In the last two Letters I discussed the structure of important secondary (upward) reactions, and it was stated that most secondaries take the form of two distinct upward thrusts separated by a (generally sharp) minor decline. Letter 187 ventured the opinion that the first thrust was completed and that a sharp decline could now be expected. Moreover, following a decline which might serve to correct about 1/3 to 1/2 of the

Z-A advance, I added that trading positions might be taken by those who were willing to assume the risk of "playing" against the established primary trend.

On July 12 the market did turn down, and in the space of four trading days (A-B) Industrials gave back about 1/3 of the ground gained since the June 26 lows (at B). Following that sell-off (A-B), the two Averages again rallied, but volume contracted sharply on the attempt.

The situation (as is always the case during contra-trend movements) continues to be extremely "tricky", but the following sums up my current views:

(1) Subsequent to a "panic-collapse", the Averages usually regain approximately 40-60% of the ground lost on the preceding primary downswing. In the present situation, a minimum 40% retracement of the second (190) point primary leg would take Industrials to 611. Judged by this standard, the current secondary is (so far) sub-normal in extent.

(2) Secondary reactions generally last three weeks to three months. The rise from Z began on June 26 (about one month ago). This means that the current secondary falls (so far) on the short end of the time scale.

(3) Perhaps due to the explosiveness and compression of the Z-A advance, the market now seems to have exhausted its immediate upside potential. The little rally from B did not seem to be able to generate any "lifting power" -- volume contracted sharply as the Averages pushed up from the B levels.

While the secondary uptrend is still considered to be in force, (in view of the sluggishness of the past few days) I list possible or potential danger signals as follows: (a) A joint penetration of the minor B levels on increasing volume. (b) Industrials breaking below the halfway level of the Z-A advance -- the halfway level is 563. (c) And of course, the final danger signal would be a penetration by both Averages of the bear market lows.

(4) If one or the other Average persistently refuses to break the B levels, the stage will be set for a second upward thrust of the Averages. In that event, it will be the ability or inability of the two indicators to hurdle their recent peaks at A which will determine the strength of the market.

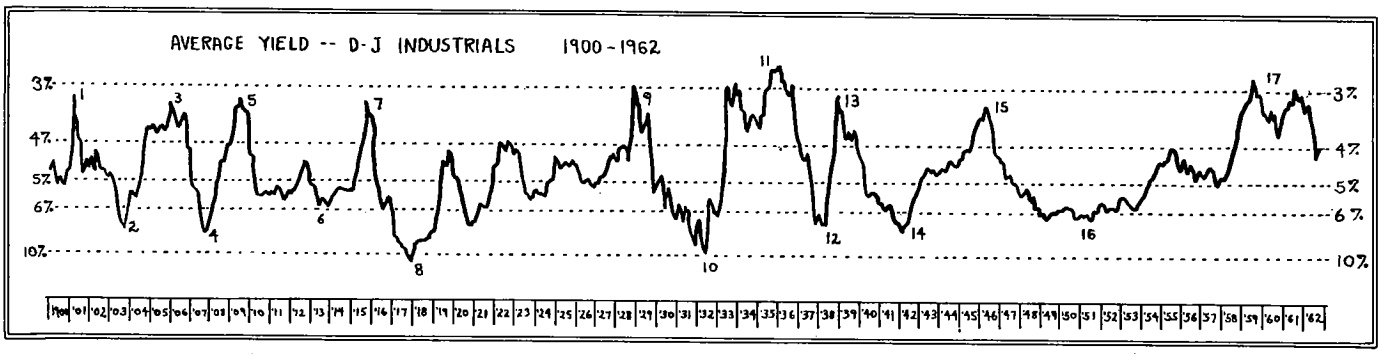
(5) One of the most common danger signals at secondary reaction tops has been non-confirmation of the Averages. Such non-confirmations are often accompanied by heavy volume. Therefore, a second thrust or rally which might take one Average (unconfirmed by the other) above the A highs (Industrials 590.27, Rails 125.49) should be regarded with great suspicion. Historically (although this has not always been the case) it has been the Rail Average which refuses to confirm at bear market rally tops. If the Rails "flatten out" during the next rally, watch out.

CONCLUSION: The primary trend continues bearish; the secondary trend turned bullish on June 26; the minor trend is obscure but will turn down if the Averages break jointly below the B points on increasing volume.

FOR THE LONG-RANGE INVESTOR "There is a very true adage," wrote the great speculator Jesse Livermore," 'you can beat a horse race, but you can't beat the races.' So it is with market operations. There are times when money can be made investing and speculating in stocks, but money cannot consistently be made trading every day or every week during the year. Only the foolhardy will try it."

Later Livermore wrote: "Speculation is very similar to playing a game of cards, whether it be poker, bridge or any similar game. Each of us is possessed with the common weakness of wanting to have an interest in every jackpot, and we certainly would like to play every hand at bridge. It is this human frailty which we all possess in some degree that becomes the investor's and speculator's greatest enemy and will eventually, if not safeguarded, bring his downfall."

In line with this thinking, I have included a chart of the Average yield on the D-J Industrial Average over the period from 1900 to the present. This study has always fascinated me, and I have written many times of yields and "values." Unlike the actual swings of the Industrial Average which are limited to a theoretical zero on the downside and a theoretical infinity on the upside, average yields are (or have been) confined to a limited range. Thus we can count seventeen definite broad swings in average yields since 1900, each swing terminating around 2.8 to 3.5% on the bull end of the scale and around 6 to 10% on the bear end of the scale. Almost without exception it can be said that each time the average Industrial yield entered the 3% range, distribution occurred. Following that distribution, the market declined sufficiently to bring the average yield back to the 6% or more zone. Only once in the last 62 years have the average yields held in the 3-4% range for more than three years prior to or during a major bull market top. That was in the period 1933 to 1936 (see chart). Over the past four years, however, that phenomenon has occurred again -- thus the years 1958 to 1962 saw average yields holding persistently within the 2.8 to 4% yield. Recently (at the June lows) the average yield temporarily dipped to



better than 4%, then back to the 3% zone again. But based on the chart, the long-term trend would now seem to be towards values and the 6% or more yield zone.

Could the market perform in unprecedented fashion -- could a new bull market be forming in this area? If the past is any guide, important accumulation (the type of accumulation which ends bear markets and starts new bull markets) will not occur until average yields are again at attractive levels.

Thus, the true investor (as distinguished from the trader) should bear Livermore's words carefully in mind. For chances are that before there is another great bull play (and I am not talking about a rally -- even a sustained rally) there will be a return to great values. One of the ways of identifying great values is the yield measurement -- 6% or more average yield on "blue-chip" stocks.

SUNDRY THOUGHTS For the last few years one of the arguments my friends advanced against the possibility of a bear market was that "it is simply too hideous to contemplate." I answered by saying bear markets were always unfortunate -- that no country could ever afford them. This, however, had not prevented them from occurring.

"But the Russians and Chinese with their 'closed economy' will take over if we have a bear market," my friends answered. "This one could be much, much worse."

"Maybe so," I replied, "but bear markets have always been interantional in scope. If we have a bear market, Russia and China will have one too. They'll be no better off than we are."

It is therefore somewhat ironic to read about the very real economic troubles now hitting China and Russia. No longer are those two nations a "showcase" for the uncommitted countries. China and Russia are simply "giants" struggling with crop failures, food shortages, rising prices, poor living standards -- and more important -- a seeming trend of increasing economic troubles.

This brings me to Humphrey Neill's concept of "contrary thinking." When too many people start thinking one way --forget it; those expectations are probably not the way things will go. Mr. Neill once published a list of "widely-expected" events--and the final reality. It was a most fascinating list, and I include some of it below.

	Consensus	Final reality
1914	Little general apprehension of war. Papers carried almost no news of international strain prior to July, 1914.	World War I
1916	Great rise of "war babies" in stock market -- boom expected to continue.	Bear market all through 1916
1919	Postwar depression widely expected.	Inflation boom occurred, known as "silk shirt era."
1929	"Permanently high plateau".	"crash"
1940	Hitler could never break Maginot line. Dutch would "flood" dikes and stop Nazis.	Germany ran over France and Holland as if they never existed.

1946-49	A post-war slump with 8-12 million unemployed was on the way.	Thirteen years of boom starting in 1949.

And now I will add a few observations of my own.

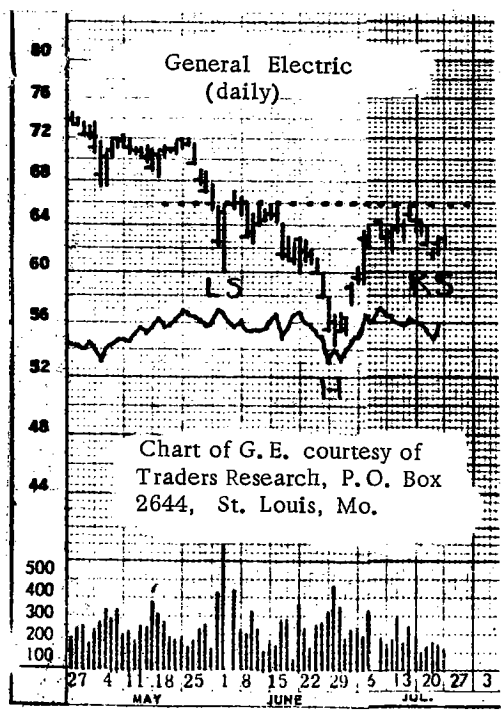
1956-57	U. S. invincible. Russia still a primative nation.	"Sputnik", and a world astounded at Russian scientific advances.
1958-61	Russia way ahead of U. S. in space. Communists taking over the world and apparently unstoppable. Everything going Russia's way.	Russian space progress greatly exaggerated. Russia runs into economic trouble. The rise of China as the possible great threat.
1959-61	Inflation in our times. "Buy stocks as an inflation hedge."	Commodities and stocks break badly. Gradual recognition that we face a problem of world deflation.
1962	(And this is or could be the biggest contrary development in a long time!) U. S. and Russia, the two great powers, locked in a "death-struggle" for world supremacy.	(My opinion of what could actually occur). The rise of Europe under the leadership of France and Germany as the third or even the LEADING power bloc in the world! A decline in importance of the "U. S. -Russia" struggle.

Throughout world history, the nation and nations who amassed the great hoardes of gold were the nations who held the power. Gold goes to the strong; those who possess the "strong currency (historically) have held the balance of power. (i. e., Spain in the days of the Spanish Armada, England in her Empire days, etc.). There is no doubt that gold is now flowing steadily to Western Europe. European currencies and economies are the strongest in the world. I suggest that all subscribers read the article in the July 23 issue of U. S. News & World Report entitled "Europe -- The Third Power." The sub-cap of that article reads: "Faster than anybody thought possible, the time is passing when the U. S. and Russia could call the signals for the world. That's shown by what is now happening in Europe -- uniting, growing, asserting its new-found power."

Could the great 1962 drop in stock prices be discounting the switch in the balance of power (and economic power) from the U. S. to Western Europe? Only time will tell. Yet the degrading international speculation against the dollar continues. The once mighty bastion of the U. S. economy (the dollar) is now fighting against the supreme embarrassment of devaluation.

LATE NOTES (written 10 A.M., Wednesday, July 25). Yesterday Rails broke below their preceding minor low point at B. Today the market opened lower with both Averages " in gear". A persistent refusal by Industrials to penetrate their own B level (571.24) would be a hopeful sign and would suggest that the senior Average was preparing for another try at the recent recovery peak. Conversely, if Industrials break below B and then below 563 (the halfway level of the Z-A advance), I believe the market will be in serious trouble.

In general, the performance of the market has been sub-standard (even for a secondary correction). If another thrust to or around the recent recoveries highs does not develop, we will have witnessed one of the saddest performances in t he history of post-"crash" markets (it should be remembered that a minimum 40% retracement of the second bear leg would take Industrials to 611 -- 20 points above the recent recovery peak at point A).



STOCKS The chart of General Electric depicts the potential "reverse head-and-shoulders" pattern seen in many stocks at this time. But it is also noteworthy that few stocks have so far completed their reversal. Thus, a rise above the (dotted line) "neckline" to 68 would be required before we can say that G. E. has definitely turned bullish. This has not yet occurred. Some traders prefer to buy a stock such as G. E. when it is in the current "right shoulder" area -- prior to a possible breakout (with the stipulation that they sell it if it breaks to new lows). Others will buy only on the breakout (after the stock has definitely turned bullish). During a bear market, I would lean towards the latter view.

Breakout or "buy-signals" on other stocks now in reverse head-and-shoulders patterns are as follows (these are some of the best potential reversal patterns on the Board and a test of the strength of the market may be an ability of these stocks to actually hit their reversal levels listed below): Reynolds Metal -- 29, Ford -- 45, Borg Warner -- 42, Merck -- 75, Int. Tel. & Tel. -- 43, Magnavox--35 1/2, United Fruit -- 25 1/2, Fla. Pow. & Lt. -- 63.